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TAGS: [ENRG](#) [CH](#) [EPET](#) [IN](#) [KZ](#) [ECONOMIC](#)

SUBJECT: KAZAKHSTAN: NEW SUBSOIL AMENDMENTS BROADEN STATE'S  
PREEMPTIVE RIGHTS

REF: A. ALMATY 3075

[B](#). ALMATY 3143

[C](#). ALMATY 3296

[D](#). 04 ALMATY 4843

Classified By: POEC Chief Deborah Mennuti, reasons 1.4(B) and (D).

[1](#)1. (C) Summary: On October 15, President Nazarbayev signed into law a series of amendments which expand the scope of the GOK's "preemptive rights" to cover the case of the sale of a company whose subsidiary conducts subsoil operations in Kazakhstan. The new amendments appear to have been tailor-made to apply in the PetroKazakhstan (PK) case (refs A-C), and rushed into law in advance of the PK shareholders' October 18 vote approving the company's sale to CNPC subsidiary PetroChina. Many analysts here believe the amendments were intended to increase GOK leverage in negotiations with CNPC over the disposition and pricing of PK assets, including the Shymkent refinery. While this law will be ignored by Western courts and financial regulators signing off on the sale of publicly-held companies, or shares thereof, the penalty prescribed for non-compliance -- termination of a buyer's subsoil use license -- is real, and will likely serve the amendments' intended purpose of forcing prospective buyers to seek GOK approval, and give first right to the government to purchase "strategic" assets, prior to concluding a deal. The GOK justified the new amendments on the basis of "national security." Energy Minister Shkolnik drew a parallel between the new law and the 1950 U.S. "Defense Production Act," which, as amended, provided the legal basis for the "national security" objections to CNPC's recent bid to purchase UNOCAL.

[1](#)2. (C) Summary continued. Whatever the GOK's motives in rushing the package into force, the lasting effect of the amendments is a tightening of government control over the oil sector. Furthermore, at least one prominent energy lawyer here believes that the hastily-written amendments go much further in altering the legal landscape than the GOK likely intended. Interestingly, the sale of Nelson Resources -- owned primarily by GOK insiders -- to Lukoil appears to have beat the implementation of the new law by hours. On the positive side, the amendments relax the complete ban on gas flaring in effect since January 2005, granting companies until July 2006 to submit plans for disposing of associated gas. End Summary.

New Amendments Rushed Into Law

[1](#)3. (U) President Nazarbayev signed a package of amendments related to subsoil use and petroleum operations into law on October 15, capping a rapid approval process that began on September 8 when the draft law was first submitted to the Lower House (Mazhilis). The new amendments modify three existing laws: the "Law on Oil," the "Law on Subsurface Resources and Subsurface Use," and the "Law on National Security." The amendments are logically seen as an extension of the December 2004 preemption law (ref D), which applied only to an entity selling an interest in a contract or a subsurface use right in Kazakhstan. The new law reaches upward in an oil company's customary chain of parent and subsidiary companies, extending the GOK's preemptive right "to any legal entity which may influence, indirectly or directly, the decisions made by the subsoil user." In the words (reported in the press) of First Deputy Minister of Energy and Mineral Resources Baktykozha Izumukhambetov, the amendments were drafted to confront "...cases of access to the republic's resources not by way of transaction with the subsurface user, but through indirect transactions with the parent company of the subsurface user."

[1](#)4. (U) The key passage (Article 71.3) on preemptive rights amends the "Law on Subsurface Resources and Subsurface Use" (unofficial translation): "In order to preserve and reinforce the resource and energy basis of the country's economy in newly concluded, as well as in earlier concluded, subsoil use contracts, exclusive of contracts of subsurface water and common minerals, the state has a preemptive right before the other party to the contract, or members of a legal entity that has the right for subsoil use, and other persons,

to purchase the alienable right for subsoil use (its portion)

and/or an interest (stock holding) in a legal entity that has the right for subsoil use, as well as in a legal entity which may, directly or indirectly, make decisions for and/or influence the decisions made by the subsoil user, provided such legal entity's activities are related to subsoil use in the Republic of Kazakhstan, on the terms none the worse than those offered by other buyers..."

15. (U) The penalty for noncompliance is defined in Article 45.2, clause 1. As amended, the relevant portion of the article will read: "(The) competent body has a right to cancel a contract in a unilateral way in...case of non-fulfillment of part 3 of Article 71 of the present Law regarding a state's preemptive right."

16. (SBU) According to press quotes, Energy and Mineral Resources Minister Vladimir Shkolnik told the Parliament's Lower House that the GOK "developed the bill after intensive study of U.S. legislation," and cited a U.S. "law of 1950 that stipulates a federal commission to consider all the issues of transfer to title of large assets." (Note: Shkolnik is likely referring to Section 7 of the Defense Production Act of 1950 -- which, as amended in 1988, provides for inter-agency USG review of prospective Foreign Direct Investment which may threaten national security. This process became news during CNPC's attempted purchase of UNOCAL. End Note.)

Putting Pressure on CNPC?

17. (C) Western courts ruling on the sale of shares in publicly-traded companies (such as the Alberta court currently considering PK's sale to CNPC) will, by legal necessity, ignore the GOK's presumption of preemptive rights. However, the penalty for non-compliance envisioned by the new law -- potential suspension of exploration and/or operating licenses -- will presumably be sufficient to drive any future buyers to seek prior GOK approval, and to give the GOK an opportunity to purchase desired assets in the name of "national security."

18. (C) The consensus here is that the law -- first submitted to the Lower House on September 8, 17 days after the August 22 announced sale of PK to CNPC -- was timed to increase GOK leverage in negotiations with the Chinese over disposition of PK's assets, and rushed into law in order to predate PK's official sale to CNPC. According to one variation of this argument, the intended pressure may have already borne fruit: on October 19 the official government paper, "Kazakhstanskaya Pravda," published a joint CNPC-KMG (KazMunaiGaz, the state-owned oil company) statement announcing the October 15 signature of a Memorandum of Understanding (MOU) governing KMG's "participation in the purchase of PK shares." The statement announces that KMG will receive "a right of joint management of the Shymkent refinery and a right to sell oil products on parity terms with equal shares from each side." (Comment: Experts here uniformly agree that, of all PK's assets, KMG most prizes the refinery. See Ref C. However, skeptics of the theory that the GOK and CNPC have already reached agreement point out that if the details of "joint management" of the refinery have not been agreed-upon behind the scenes -- not to mention the price of KMG's share -- the most contentious negotiations likely lie ahead, and thus the new amendments' effectiveness as leverage remains to be seen. End comment.)

19. (C) Tom Dvorak, President of PK's "Kumkol" Joint Venture (with LUKOIL), offered an alternative interpretation of events. While the announced KMG-CNPC MOU was promising, he wasn't ready to abandon the hypothesis that the GOK's real goal was, in partnership with Lukoil, to scuttle PK's sale to CNPC in order buy PK later at a deep discount. As evidence of Lukoil's intent, Dvorak pointed to its lawsuit in Canadian court to stall finalization of PK's sale until after Lukoil's claim to a preemptive right to the Kumkol field had been subjected to international arbitration. Such a delay, Dvorak worried, would surely induce CNPC to rescind its purchase offer. If the MOU was really a sign of GOK-CNPC agreement, Dvorak concluded, why hadn't Lukoil dropped its case in Canadian courts? (Comment: One answer, of course, is that Lukoil is using its own leverage in negotiations with CNPC to buy-out the latter's 50% (PK) share of the Kumkol field. End

Comment.) According to Dvorak, yet another possible scenario, which Energy Minister Shkolnik's recent comments to the press have reinforced, was that KMG and the Ministry of Energy were at odds over the sale -- in which case KMG's MOU with the Chinese represented less than it appeared.

The Law with Unintended Consequences

10. (C) Legal analysts here fear that the hastily-written law may have many unintended consequences. DentonWildeSapte's Marla Valdez identified two: first, the operative definition of the entities over which the GOK exerts its new preemptive rights (paragraph 4) was much too broad, and "probably will apply in more instances than not." Second, the amendments to the National Security Law appear to obligate the GOK to consider numerous routine administrative acts, including "concluding and monitoring (subsurface) contracts," as issues of "national security." However, according to previously existing GOK legislation, fundamental provisions of subsoil contracts, including contract "stability," do not apply when questions of national security arise. This conclusion -- which Valdez speculates was unintended -- not only contradicts other fundamental Kazakhstani laws (the January 2005 tax code, for example, grants tax stability to PSA contracts entered into after January 2004), but, if implemented, would alter the fundamental operating principles of Kazakhstani subsoil contracts. The authors of the amendments, Valdez concluded, "were either really stupid or really devious."

Nelson: In Under the Wire  
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11. (C) Kazakhstan's other headline oil deal -- the sale of Nelson Resources, a Bermuda-based and Toronto stock exchange listed company, to Lukoil -- would also appear, at first glance, to fall within the purview of the new legislation. Outgoing Nelson Chief Operating Officer Simon Gill told Econoff, however, that Nelson's well-connected majority owners (which include the President's son-in-law) managed to finalize sale of their shares to Lukoil on October 14, thereby narrowly escaping application of the new law.

Relief on Gas Flaring  
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12. (SBU) One provision of the new amendments which will be welcomed by oil companies is the relaxation of the GOK's strict ban on gas flaring, enacted in January 2005. The oil companies had made adoption of a grace period, or implementation phase, a priority in their 2005 lobbying efforts.

13. (C) Comment. Many important aspects of this law -- including its intended or effective scope -- are not yet clear. Nor do we have a reliable sense of how the law is affecting the closed-door negotiations between the GOK, CNPC, and Lukoil. We are left with the impression that the GOK is once again tightening its control over the oil sector, leaving less and less to the workings of the free market. Finally, the fact that these amendments appear to have been cobbled together and rushed to beat an October 18 deadline only strengthens the perception -- already ingrained due to the see-saw tax changes of 2004 and 2005 -- that the GOK lacks a coherent, overarching policy toward energy investment. End Comment.  
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